

March 5, 2004

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: SR-NASD-2004-040 - Extension of Pilot Rule in IM-10100(f) of the NASD Code of Arbitration Procedure Regarding Waiver of California Arbitrator Disclosure Standards; Immediate Effectiveness Requested

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Jean Feeney, Vice President and Chief Counsel, NASD Dispute Resolution, at (202) 728-6959; e-mail jean.feeney@nasd.com. The fax number is (202) 728-8833.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-2004-040
Consists of 13 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Dispute Resolution, Inc. (“NASD Dispute Resolution”), is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to extend the pilot rule in IM-10100(f) of the NASD Code of Arbitration Procedure (“Code”) that requires industry parties in arbitration to waive application of contested California arbitrator disclosure standards upon the request of customers or, in industry cases, of associated persons with claims against member firms or other associated persons, for an additional six-month pilot period beginning on March 31, 2004. This extension does not affect existing rule text.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the NASD Dispute Resolution Board of Directors on January 21, 2004, which authorized the filing of the rule change with the SEC. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt NASD Rules without recourse to the membership for approval. NASD requests that the rule change become effective on filing and that it become operative on March 31, 2004.

(b) Questions regarding this rule filing may be directed to Jean I. Feeney, Vice President and Chief Counsel, NASD Dispute Resolution, at (202) 728-6959.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

Effective July 1, 2002, the California Judicial Council adopted a set of rules, “Ethics Standards for Neutral Arbitrators in Contractual Arbitration” (“California Standards”),¹ which contain extensive disclosure requirements for arbitrators. The rules were designed to address conflicts of interest in private arbitration forums that are not part of a federal regulatory system overseen on a uniform, national basis by the SEC. The California Standards imposed disclosure requirements on arbitrators that conflict with the disclosure rules of NASD and the New York Stock Exchange (“NYSE”). Because NASD could not both administer its arbitration program in accordance with its own rules and comply with the new California Standards at the same time, NASD initially suspended the appointment of arbitrators in cases in California, but offered parties several options for pursuing their cases.²

NASD and NYSE filed a lawsuit in federal district court seeking a declaratory judgment that the California Standards are inapplicable to arbitration forums sponsored by self-regulatory organizations (“SROs”).³ That litigation is currently pending on appeal. Since then, other lawsuits relating to the application of the California Standards to SRO-sponsored arbitration have been filed, some of which are still pending.

¹ California Rules of Court, Division VI of the Appendix.

² These measures included providing venue changes for arbitration cases, using non-California arbitrators when appropriate, and waiving administrative fees for NASD-sponsored mediations.

³ See Motion for Declaratory Judgment, NASD Dispute Resolution, Inc. and New York Stock Exchange, Inc. v. Judicial Council of California, filed in the United States District Court for the Northern District of California, No. C 02 3486 SBA (July 22, 2002), available on the NASD Web site at: http://www.nasdaq.com/pdf-text/072202_ca_complaint.pdf.

To allow arbitrations to proceed in California while the litigation was pending, NASD implemented a pilot rule to require all industry parties (member firms and associated persons) to waive application of the California Standards to the case, if all the parties in the case who are customers, or associated persons with claims against industry parties, have done so.⁴ In such cases, the arbitration proceeds under the NASD Code of Arbitration Procedure, which already contains extensive disclosure requirements and provisions for challenging arbitrators with potential conflicts of interest.⁵

The pilot rule, which was originally approved for six months on September 26, 2002, has been extended and is now due to expire on March 31, 2004. Because the pending litigation regarding the California Standards is unlikely to be resolved by March 31, 2004, NASD requests that the effectiveness of the pilot rule be extended through September 30, 2004, in order to prevent NASD from having to suspend administration of cases covered by the pilot rule.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that expediting the appointment of arbitrators under the proposed waiver, at the request of

⁴ Originally, the pilot rule applied only to claims by customers, or by associated persons asserting a statutory employment discrimination claim against a member, and required a written waiver by the industry respondents. In July 2003, NASD expanded the scope of the pilot rule to include all claims by associated persons against another associated person or a member. At the same time, the rule was amended to provide that when a customer, or an associated person with a claim against a member or another associated person, agrees to waive the application of the California Standards, all respondents that are members or associated persons will be deemed to have waived the application of the standards as well. The July 2003 amendment also clarified that the pilot rule applies to terminated members and associated persons. See Securities Exchange Act Rel. No. 48187 (July 16, 2003), 68 FR 43553 (July 23, 2003) (File No. SR-NASD-2003-106).

customers and associated persons with claims against industry respondents, will allow those parties to exercise their contractual rights to proceed in arbitration in California, notwithstanding the confusion caused by the disputed California Standards.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

The proposed rule change is effective upon filing pursuant to Section 19(b)(3)(A) of the Act and paragraph (f)(6) of Rule 19b-4 thereunder, in that the proposed rule change does not significantly affect the protection of investors or the public interest; does not impose any significant burden on competition; and does not become operative for 30 days from the date on which it was filed or such shorter time as the Commission may designate. NASD believes that the proposed rule change would protect investors and further the public interest by allowing customers, and associated persons with claims against other industry respondents, to proceed in

⁵ The NYSE has a similar rule, Rule 600(g).

arbitration in California, notwithstanding the confusion caused by the disputed California Standards.

NASD requests the Commission to waive the five-day advance notice requirement and the requirement that the rule change not become operative for 30 days after filing. NASD proposes to make the proposed rule change operative on March 31, 2004, when the current pilot rule would otherwise expire. NASD believes that this action is necessary for the protection of investors to continue to administer cases despite the confusion over the new California Standards, and that immediate effectiveness will avoid disruption in the arbitrations of parties who wish to pursue their cases in arbitration under the NASD Code of Arbitration Procedure.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD

BY: _____
Barbara Z. Sweeney, Senior Vice President and
Corporate Secretary

Date: March 5, 2004

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-

File No. SR-NASD-2004-040)

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. Regarding Waiver of California Arbitrator Disclosure Standards

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on _____, the National Association of Securities Dealers, Inc. (“NASD”), through its wholly owned subsidiary, NASD Dispute Resolution, Inc. (“NASD Dispute Resolution”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Dispute Resolution. NASD has designated the proposed rule change as constituting a “non-controversial” rule change under paragraph (f)(6) of Rule 19b-4 under the Act,³ which renders the proposal effective upon receipt of this filing by the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 17 CFR § 240.19b-4

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing to extend the pilot rule in IM-10100(f) of the NASD Code of Arbitration Procedure, which requires industry parties in arbitration to waive application of contested California arbitrator disclosure standards, upon the request of customers, and associated persons with claims against other industry parties, for a six-month period.

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

Effective July 1, 2002, the California Judicial Council adopted a set of rules, "Ethics Standards for Neutral Arbitrators in Contractual Arbitration" ("California Standards"),⁴ which contain extensive disclosure requirements for arbitrators. The rules were designed to address conflicts of interest in private arbitration forums that are not part of a federal regulatory system overseen on a uniform, national basis by the SEC. The California Standards imposed disclosure

⁴ California Rules of Court, Division VI of the Appendix.

requirements on arbitrators that conflict with the disclosure rules of NASD and the New York Stock Exchange (“NYSE”). Because NASD could not both administer its arbitration program in accordance with its own rules and comply with the new California Standards at the same time, NASD initially suspended the appointment of arbitrators in cases in California, but offered parties several options for pursuing their cases.⁵

NASD and NYSE filed a lawsuit in federal district court seeking a declaratory judgment that the California Standards are inapplicable to arbitration forums sponsored by self-regulatory organizations (“SROs”).⁶ That litigation is currently pending on appeal. Since then, other lawsuits relating to the application of the California Standards to SRO-sponsored arbitration have been filed, some of which are still pending.

To allow arbitrations to proceed in California while the litigation was pending, NASD implemented a pilot rule to require all industry parties (member firms and associated persons) to waive application of the California Standards to the case, if all the parties in the case who are customers, or associated persons with claims against industry parties, have done so.⁷ In such

⁵ These measures included providing venue changes for arbitration cases, using non-California arbitrators when appropriate, and waiving administrative fees for NASD-sponsored mediations.

⁶ See Motion for Declaratory Judgment, NASD Dispute Resolution, Inc. and New York Stock Exchange, Inc. v. Judicial Council of California, filed in the United States District Court for the Northern District of California, No. C 02 3486 SBA (July 22, 2002), available on the NASD Web site at: http://www.nasdr.com/pdf-text/072202_ca_complaint.pdf.

⁷ Originally, the pilot rule only applied to claims by customers, or by associated persons asserting a statutory employment discrimination claim against a member, and required a written waiver by the industry respondents. In July 2003, NASD expanded the scope of the pilot rule to include all claims by associated persons against another associated person or a member. At the same time, the rule was amended to provide that when a customer, or an associated person with a claim against a member or another associated person, agrees to waive the application of the California Standards, all respondents that are members or associated persons will be deemed to have waived the application of the standards as well. The July 2003 amendment also clarified that the pilot rule applies to terminated members and associated persons. See Securities Exchange Act Rel. No. 48187 (July 16, 2003), 68 FR 43553 (July 23, 2003) (File No. SR-NASD-2003-106).

cases, the arbitration proceeds under the NASD Code of Arbitration Procedure, which already contains extensive disclosure requirements and provisions for challenging arbitrators with potential conflicts of interest.⁸

The pilot rule, which was originally approved for six months on September 26, 2002, has been extended and is now due to expire on March 31, 2004. Because the pending litigation regarding the California Standards is unlikely to be resolved by March 31, 2004, NASD requests that the effectiveness of the pilot rule be extended through September 30, 2004, in order to prevent NASD from having to suspend administration of cases covered by the pilot rule.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that expediting the appointment of arbitrators under the waiver rule, at the request of customers and associated persons with claims against industry respondents, will allow those parties to exercise their contractual rights to proceed in arbitration in California, notwithstanding the confusion caused by the disputed California Standards.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

NASD has designated the proposed rule change as one that: (i) Does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate. Therefore, the foregoing rule change has become effective pursuant to Section 19(b)(3)(A) of the Act 6 and Rule 19b-4(f)(6) thereunder. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate the rule change if it appears to the Commission that the action is necessary or appropriate in the public interest, for the protection of investors, or would otherwise further the purposes of the Act.

Pursuant to Rule 19b-4(f)(6)(iii) under the Act, the proposal may not become operative for 30 days after the date of its filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, and the self-regulatory organization must file notice of its intent to file the proposed rule change at least five business days beforehand.

NASD has requested that the Commission waive the five-day prefiling requirement and the 30-day operative delay so that the proposed rule change will become immediately effective

⁸ The NYSE has a similar rule; Rule 600(g).

upon filing. The Commission believes that waiving the five-day pre-filing provision and the 30-day operative delay is consistent with the protection of investors and the public interest. Waiving the pre-filing requirement and accelerating the operative date will merely extend a pilot program that is designed to provide investors, and associated persons with claims against industry respondents, with a mechanism to resolve their disputes. During the period of the extension, the Commission and NASD will continue to monitor the status of the previously discussed litigation. For these reasons, the Commission designates the proposed rule change effective immediately and operative on September 30, 2003.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary